DOW THEORY LETTERS INC.

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THE MARKET: What was the market saying and seeing when it dropped 25% in the period of February to October, 1966? The market was obviously predicting tighter money. Tight money arrived, but interest rates have now slackened a bit. The market was guessing that the war in Vietnam would continue. But that was no revelation; I guessed that the war would go on, and so did many other observers. A dozen other examples could be offered, but all such listings would simply obscure the big picture. For what I really believe the market has been saying during 1966 is that the beginning of the end of the greatest bull market and boom in American history has arrived. The collapse in the Dow from the 995.15 peak to the October low of 744.32 was, in my opinion, Wall Street's way of telling us that the big binge of the 1950's and '60's is over. Act 1 of the bear market has passed into history. No one wanted to believe it back in February and March; they still don't. But I firmly believe that that is the meaning of the 1966 debacle.

Some of the statistical data is now falling into line with "the verdict of the marketplace." And although business seems to be trying to preserve that "old boomy feeling," many leading economic series are beginning to flash signals of potential "trouble ahead." For instance, the Magazine of Wall Street constructs a "Trend Forecaster," and this composite of 8 leading economic indices has had excellent success in the past. All 8 of these indices now appear to have topped out, and on the latest (October) reading, 5 of the indices had been declining for 7 months or more. Among these indices, stock prices, raw industrial commodity prices, business failures and housing starts are all in definite bear trends. Durable goods new orders, new incorporations, average hours worked and commercial and industrial building awards are well off their highs, but they have not yet established steep bear trends.

The overall trend of these 8 indicators has prompted the Magazine of Wall Street to comment: "In this generally somber outlook, virtually the only bright spot is the continued rise in order backlogs, which provides a cushion against a decline in output for the time being. However, if the indicators show no improvement during the next few months and backlogs begin to turn down, it is hard to see how a business decline of some magnitude can be avoided."

Meanwhile, back on Wall Street nobody seems to take the thesis of a primary bear market very seriously. Almost every analyst is offering comparisons with 1962, and a few are

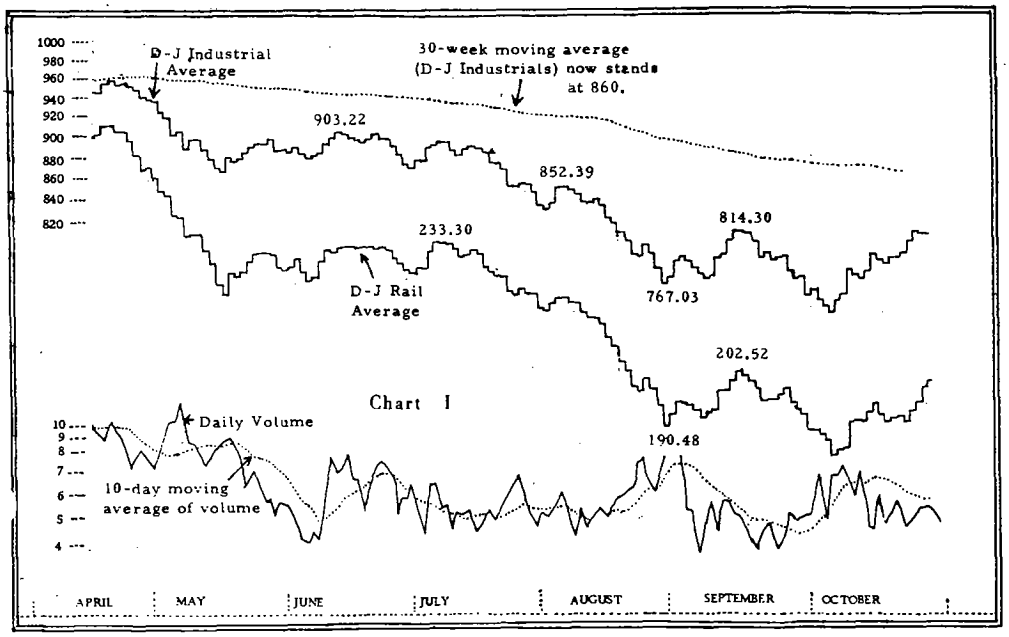
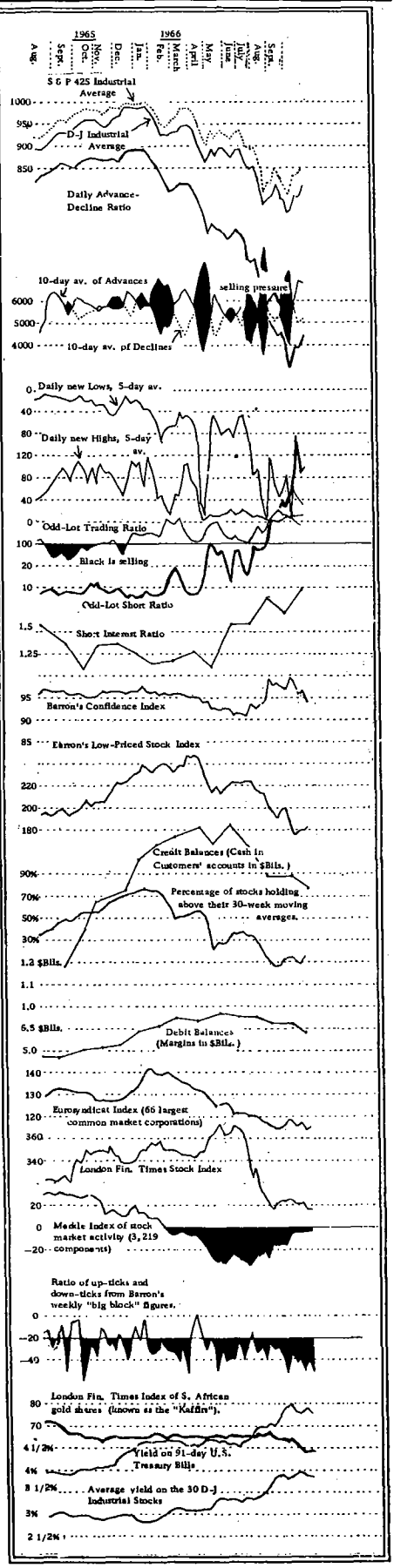


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Euroyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Meckle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

inviting comparisons with 1957, 1953 and even 1946. But as seen on the annual chart which appeared in the last Letter, none of these previous declines even broke the long-term upward thrust which has held in effect since 1942. I expect this bear market to do just that -- probably within six months or less.

The September-October (1966) decline halted on October 7 at 744.32 on the Industrial Average. Much is being made of the fact that the latest slide halted in the 740 area -- exactly at the level of the 1961 peak. The 1962 collapse halted at 535.76 -- exactly at the level of the preceding 1956 and 1957 tops. Following the 1962 low, the market turned around and pushed up to new highs. Isn't it probable, if not logical, that 1966 will repeat the performance of 1962? It is possible, but I do not think it is going to happen this time. I believe that those who are counting on this being "another 1962" are going to be discouraged and disillusioned over the next year or so. But the latest reversal, occurring as it did at the 1961 peak, is bound to stir hopes, to give buyers confidence, and to invite comparisons with 1962 and with the explosive and persistent advance which followed the 1962 lows.

Along these lines I was most interested to read the comment of Investors Intelligence (October 19). This organization makes a survey of leading services. After noting that 61% are now "bearish," they note: "Is this bullish? No. The reason for this is that only a handful of the bears are unqualifiedly bearish. About 90% of them give the bear market lip service but are talking about a base being in the process of formation from which a new bull market will begin, that the lows may already have been seen, and even if not, the worst is already over. They seem to be waiting for the right moment to turn bullish. Contrary Opinion, therefore, would be that a base is not being formed and that the lows so far made will be exceeded by an unexpected degree."

Perhaps the strongest weapon in the bull arsenal is the current record short interest and the 1.99 short interest ratio. Hasn't a high short interest ratio always held the market in a firm basing area before? If we are talking about the action within memory of most of today's younger analysts the answer is yes. But I see the picture a different way, and that way is within the framework of a primary bear market. In a bull market the shorts are speculating against the primary trend, and the stockholders are always right in the long-term sense. In a bull market the primary trend will ultimately crush the short sellers and build profits for the stockholders.

But in a bear market the short sellers are right in the long-term sense. How large a short interest can be correct in a bear market? Look at it this way. The first short interest figures ever announced on Wall Street showed 5.6 million shorts in May, 1931 (during a primary bear market). At that time it is estimated that there were about 1 million shareholders in the nation. Yet that high short interest failed to halt the primary bear market. By July, 1932, the Dow had lost 74% of its value. Today, with an estimated 20 million shareholders, the short interest has risen to 12.6 million. Is this a huge short interest for a bear market? I keep thinking that with less than three times the shorts of 1931, we now have 20 times the number of participants. We know that the short interest tends always to be high during a primary bear market. But I am not at all convinced that the short interest is really "too high" now. Today's short interest may allow for explosive and even extended rallies, but seen within the context of a primary bear market the short interest is not now a major "prop," it is an unknown quantity. We simply have had too little experience with technical data within primary bear markets.

CURRENT POSITION: I have stated that I believe we are now in the second (psychological) phase of this bear market. This is traditionally the longest phase. The bear market began in February at 995.15. In August the Industrial Average violated its 1965 low of 840.59. The shattering of the 1965 low concluded what I felt was the first phase of the bear market. The "froth and bubbles" of the preceding bull market's final speculative advance had been erased, and this is exactly what "is supposed to happen" during the first phase of a bear market.

NOTES & QUOTES: It's a sort of standing joke with investors "in the know" that Wall Street analysts and market letter writers do not or "are not allowed to" write what they really think. "Oh, it's all right to be the biggest bull in town when the market's going up," I have been told, "but when the market's on its way down you guys become just a bunch of Wall Street 'politicians' telling us poor slobs that it's not as bad as it seems. Why don't you fellows have the guts to write what you think at all times?"

Well, there are a few analysts who do exactly that. They aren't always right by any means, but they always write what they think. And believe me, the pressure to "soft soap" the customers can be pretty intense at times. Personally, I have never worked for a financial institution or a brokerage house, but I have heard many an unhappy tale from my cohorts. Men like Joe Granville and the late Les Weytzner knew what pressure was, and their stories are anything but pleasant. So right here and now I want to take my hat off to these men. They are the fellows, right or wrong, who say what they want to say, and they are willing to put their jobs or their businesses on the line when they say it. How many of us have the guts or principles to do that? I place integrity and intelligence above all else in this business. We all make mistakes (and sometimes they are whoppers), but if a man hasn't got those two qualities I won't read him.

On October 21 I received a special report from Alden R. Wells, and it was not without emotion that I read the first paragraph. "I regret that the September Monetary Report was not sent to you. Purcell, Graham & Co. had demanded changes in it which were not acceptable to me. Consequently I have joined my friend Phil Herzig of P.R. Herzig & Co., members of the New York Stock Exchange, 50 Broadway, New York, 10004. I hope for your continued cooperation." Alden Wells is one of the these rare men of intelligence and integrity; he's the kind of man I read. I don't care whether Purcell, Graham & Co. had legitimate "beefs" or not (and don't kid yourself, brokerage houses can have problems too), I still like to read Alden Wells undiluted and unadulterated. Would that there were more men (in Washington, Wall Street and everyplace else) like him.

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I just purchases and read a new little book put out by my friends at Simon & Schuster. The book bears the remarkable title, "WIPED OUT, How I Lost A Fortune In The Stock Market While The Averages Were Making New Highs." My first thought (I buy almost every new stock market book) was, "This little 124 page volume is much too expensive at $3.50." My second thought was, "The author is listed as anonymous. Maybe the book is a phoney." Upon reading the book I decided that the book was well worth the money and that the author was anything but a phoney. He must exist; the whole ring of the book is just too true.

The book is a "how to do it" of failure in the market. The author details his trials and tribulations with brokers, his own greed, his loss of psychological "cool," his loss of all his money. It is a testament to the disastrous effects of in-and-out trading, of lack of patience and of ignorance. Almost nowhere, for instance, did the author talk of investing in harmony with the primary trend. I recommend this book to all my subscribers. It's a lot cheaper (and less painful) to read about another man's mistakes than to make them yourself. The author of Wiped Out can teach you all about mistakes in the market, he made most of them, and he did it in a bigger way then most of us would dare.

It can be seen that the first bear market phase lasted from February to August or about 6 months. The second phase might be expected to last about two or three times as long as the first phase, and this means that the second phase could easily carry for a year to 18 months beyond August, 1966. The second phase is not only the longest phase but it is almost always the most deceptive. Past history indicates that during the second phase of a bear market one can expect both violent corrections and severe panic declines. It is during the second phase that business traditionally turns down, and the primary bear forces will then become apparent in the economy as well as the stock market.

I now place us in the early stages of the second phase. The October rise exhibits the violent type of action which is so characteristic of a bear market's second phase. I "sense" that the current rally will be the most deceptive (and perhaps the largest) to appear so far. The rally will probably terminate amid great public enthusiasm and widespread talk of "a new bull market." If this bear market follows the course of other bear markets, Wall Street is going to prove a costly experience for most traders before the next 3 to 6 months are out.

We cannot know for sure whether the rise which began in October is fated to be a full correction of the entire February to October drop, or simply a correction of the last (June to October) primary leg. A 50% retracement of the entire bear market decline could return the Dow to the 870 area, but I would not expect any correction to go much further than that. The June to October primary downward leg carried from 903.22 to 744.32. A "normal" 1/3 to 2/3 retracement of this last primary leg would take the Dow to the 792-847 area (thus the current rally has already moved above the minimum 792 zone). The first step towards an extended correction of the entire bear market would be a bettering of the September 15 peaks of 814.30 (Industrials) and 202.52 (Rails). Unless both Averages succeed in hurdling those levels, I suggest that subscribers hold their hopes for a full retracement of the entire February to October bear market decline in abeyance.

This rally has formed the typical "straight-up" structure so typical of bear market rallies. Such action means that most traders are forced to come in after the Averages have already risen 30 to 40 points, always a dangerous procedure. Secondly, it has been difficult to "pick the winners" on this rise. For instance, many glamor stocks have moved sideways or down during the advance while blue-chips have spearheaded the advance. But even here, such stocks as GM and Owens-Illinois have moved sideways while others such as Proctor and Gamble and Standard of California have risen sharply. We cannot count (as is the case during a bull market) on the primary trend "bailing us out" of our mistakes in a bear market. This is why scalping operations during a primary bear trend are often so costly and frustrating. My advice: leave the rally alone. Potential profits are seldom worth the sweat and aggravation in this type of market.

PRICE-EARNINGS RATIOS: Probably no area of Wall Street analysis is subject to more sheer nonsense than that which deals with price-earnings ratios. Currently, it seems to me that the price-earnings nonsense is even more prevalent than usual. For this reason, I believe that a bit of history about P/E ratios is warranted.

"At estimated 1966 earnings of $60, the Dow is now cheap; it is selling for around 13 times earnings against a 1961 peak P/E ratio of 23 times earnings and a 1966 peak P/E ratio of almost 17 times earnings." That is the standard argument currently being used to demonstrate why the Dow is "cheap," and why the majority of quality stocks are now a "buy" (of course, the bulls hasten to add that the high P/E glamour stocks are still too high, and who needs secondary issues when the blue-chips and Utilities are so attractively priced).

Here is where we might study history. We are now in a primary bear market. For this reason, we can expect earnings to head generally lower. Secondly, we can expect investors' sentiment to deteriorate which means that generally, the price people pay for earnings will be heading down (regardless of what earnings actually do).

Note on the accompanying table that in 1929 at the high the Dow sold for 19 times earnings of $19.94. This was below

Price/Earning Ratios, D-J Industrial Average--

YEARS	PRICE RANGE		EARNINGS	P/E RATIOS HIGH	P/E RATIOS LOW
1922	103	79	$ 9.11	11.3	8.7
1923	105	86	8.25	12.7	10.4
1924	121	88	10.88	11.1	8.1
1925	159	115	13.89	11.5	8.3
1926	167	135	11.39	14.7	11.9
1927	202	153	8.72	23.2	17.5
1928	300	191	15.97	18.8	12.0
1929	386	195	19.94	19.3	10.0
1930	397	154	11.02	27.0	14.0
1931	197	72	4.09	48.1	18.0
1932	90	41	0.93 Deficit	----	----
1933	110	50	2.78	39.1	18.0
1934	111	85	4.60	24.1	18.5
1935	149	96	6.86	21.7	14.0
1936	186	142	10.07	18.5	14.1
1937	196	113	11.49	17.0	9.8
1938	159	98	6.01	26.1	16.3
1939	158	120	9.18	17.0	13.1
1940	153	110	10.99	13.9	10.0
1941	134	106	11.64	11.5	9.1
1942	120	93	9.2[illegible]	13.0	10.1
1943	146	119	9.74	15.0	12.2
1944	153	134	10.07	15.2	13.3
1945	197	151	10.56	18.6	14.3
1946	213	161	13.63	15.6	11.8
1947	188	163	18.80	10.0	8.7
1948	194	164	23.07	8.6	7.1
1949	201	161	23.54	8.5	6.8
1950	237	195	30.70	7.7	6.4
1951	277	234	26.59	10.4	8.9

1927's peak P/E ratio of 23, and at the 1929 highs many "clever" analysts called attention to this fact. But the market was looking ahead, and it knew that 1929's earnings were not as "good" as 1927's earnings. Then came the crash and the beginning of the collapse in business. The 1929 to 1932 earnings smash, in fact, came faster and harder than the stock market could discount. Consequently, with 1930 earnings on the Dow of only $11, the peak P/E ratio rose to 27. At the 1930 low for the Dow, the P/E ratio was only 14. Did a P/E ratio of 14 mean that the Dow was "a bargain?" Hardly, for the bear market and the earnings slide was to continue.

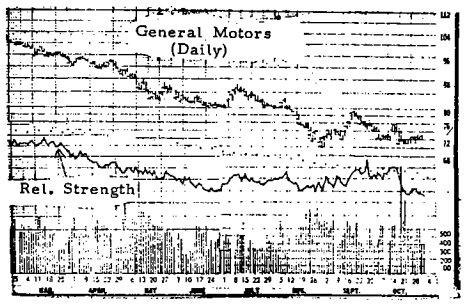
In 1931, with Dow earnings down to $4, the P/E ratio for the Dow fluctuated between a high of 48 and a low of 18. Did this mean that the Dow was overpriced in 1931? Not necessarily, and the P/E ratio argument became even more confusing in 1932 when the P/E ratio on the Dow skyrocketed to infinity ("infinity" since earnings on the Dow in 1932 actually collapsed to their first cumulative deficit). Obviously, the price of the Dow in 1932 was not going to drop to zero despite deficit earnings. As a matter of fact, during 1932 stocks were forming a great "bottom" area, and during that year Wall Street provided what in retrospect proved to be the most fabulous "bargain counter" in equity history.

Now let us examine the action during the 1937 bear market. At the '37 high the peak P/E ratio for the Dow was 17 (figured on earnings of $11.49). This P/E ratio was well below any peak ratio of the preceding five years, and on this basis many analysts insisted that stocks at the '37 highs were "still a bargain." But a vicious primary bear market set in during 1937, and by mid-1938 the Dow had cut itself in half. At the 1938 lows the P/E ratio was down to 16. By 1939 the P/E ratio hit a low of 13. In 1940 the ratio sank to a low of 10. In fact, all during 1939 to 1942 one could have purchased the Dow at around 10 times average earnings. Obviously, bargain P/E ratios alone did not mean that the bottom had arrived. The bottom was ultimately signalled by the market itself, and those who purchased stocks on the basis of 1939 and 1940 P/E ratios had cause to regret it by the time 1942 arrived.

As if to confuse the poor investor, the 1946 bull market peak and its aftermath provided a change in the "normal" bear market earnings trend. Stocks topped out in 1946 with a peak P/E ratio of only 15.6. By 1947, with earnings actually rising, the Dow had lost 25% of its value, and the Dow could have been bought at a low P/E of 8.7. With earnings still rising (!) in 1948 the Dow could have been purchased at a low P/E of 7.1. By 1949 with earnings holding steady the Dow offered purchasers a chance to buy at an incredible low P/E of 6.8. What was happening? The 1946-49 bear market carried into 1949, but it was primarily a bear market in investors' psychology. The "great post-War depression" was supposed to be "just around the corner," and regardless of earnings, Wall Street simply did not want stocks. Thus the fabulous values of 1949 were values based on depressed investors' psychology, not depressed stock earnings.

What can we conclude from this study? During a primary bear market, investors' sentiment and actual stock earnings are probably both going to head down. This is going to play havoc with P/E ratio concepts. If earnings hold up relatively well, but the market goes down on investors' sentiment, then stocks are going to provide some attractive (i.e. low) P/E ratios. If earnings collapse along with sentiment, then stocks are going to head lower even though P/E ratios may appear high. In all (see the last Letter), average dividend yield is probably a much better criterion with which to gauge the position of the market than are P/E ratios. Without taking into account the direction of the primary trend of the market, bullish or bearish cases based on P/E ratios are apt to be as deceptive as they are useful.

LATE NOTES: As stated before, it is possible that a bottom of intermediate significance is being formed. If so, the odds would still favor (based on past experience) a second decline which may or may not rupture the October low of 744.32. On the second decline there should be a decided switch (something which has not yet occurred) to less odd-lot buying or to actual odd-lot selling. (See discussion in last letter).



STOCKS: I have written before of the major significance of two N.Y.S.E. stocks, General Motors and duPont (Letter 316). I noted then that "Evidently, when the equities of these two giants, whose purchasing and selling power affects (directly or indirectly) almost everybody in the nation, are in a declining trend, the implications are so powerful that the entire market can be expected to follow."

I have been watching the action of DD and GM with utmost care during the current rally. Of interest is the fact that the relative strength lines of both these great stocks broke to new lows last week. This is not encouraging either for these stocks or for the market. It suggests, in fact, that GM and DD could establish new lows on any forthcoming decline. Consequently, I continue to suggest caution on the part of my subscribers regarding the period ahead (even from a "secondary upturn" standpoint). The weakness of DD and GM "tipped us off" during March of the rough markets ahead. Although I do not like to attach too much significance to single technical phenomenon, I want my subscribers to watch the trend of DD and GM carefully during the weeks and months ahead. (Charts courtesy of Traders Research, Inc., 1431 Pearl Ave., Alton, Ill. 62003).